1951

Budget Homes, Inc. v. State Tax Commission : Defendant's Reply to Brief of Plaintiff in Answer to Defendant's Petition for Rehearing

Utah Supreme Court

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Case No. 7605

IN THE SUPREME COURT

of the

STATE OF UTAH

BUDGET HOMES, INC., a corporation,

Plaintiff,

vs.

STATE TAX COMMISSION,

Defendant.

DEFENDANT'S REPLY TO PLAINTIFF'S BRIEF IN ANSWER TO DEFENDANT'S PETITION FOR REHEARING

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STATEMENT

This reply is filed pursuant to order of the Chief Justice dated October 23, 1951. The Tax Commission appreciates the opportunity of filing this reply in view of the serious and important issue presented by this case.

The Commission is, of course, fully aware of the difficulties involved in persuading the Court to rehear a case. Ordinarily when a case is tried, appealed, briefed, argued and decided, all aspects of the case have been thoroughly explored by the Court. In such circumstances

a petition for rehearing travels a worn path. The fact, however, that the rules do provide for a rehearing procedure is at least an indication that on some occasions, however rare they may be, a miscarriage of justice may occur. This case is such an occasion.

To justify the rehearing of a case, counsel should be able to point to some decisive law applicable to the issue of the case which was overlooked by the Court and which, if considered, would lead the court to a different result. This case is such an instance.

We make no reply herein to Plaintiff's charge of inconsistency other than to state that far above any duty on the part of Counsel to be consistent, if such duty there be, is the duty to bring to the Court all of the facts and all of the law necessary to enable the Court to arrive at a correct decision of the case. Consistency is not such a jewel as to prevent the suppression on rehearing of the law applicable to the case where such law was not previously considered by the Court.

Nor do we think it behooves any taxpayer, especially one coming into Court so soaked and dripping with illegality as this one, to imply that the Tax Commission as judge, prosecutor and jury failed to give the taxpayer a fair and impartial hearing. Any remarks or suggestions which Counsel may have for the improvement of administrative procedures in the State of Utah should, we think, be directed to the appropriate authorities independently and not as an argument in this case.

The Commission's petition for rehearing here rests on the ground that Budget Homes, Inc. was not liquidated or dissolved in law and therefore continued in business in fact. We argue that the Court in its opinion by assuming that the assets of Budget Homes, Inc. were distributed to the stockholders in a genuine and bona fide liquidation, assumed the very point in issue in the case. We argue that by the wholesale violation of the Utah Statutes relating to the liquidation and dissolution of Utah corporations, the so-called liquidation of Budget Homes, Inc. was illegal, abortive and of no effect. We argue that in violating the corporation laws, the penal code and the public policy of the State of Utah, Budget Homes, Inc. and its four shareholders have by their illegality forfeited those tax benefits which are reserved for those who comply with our statutes. We argue that the Tax Commission and this Court cannot recognize as valid for tax purposes that which is in clear and admitted violation of the civil and penal code of this state. We argue that an illegal transaction is a sham transaction.

How does Plaintiff meet this argument? As we read his brief, he argues that all of the provisions in the Utah Statutes covering the lawful liquidation and distribution of the assets of a Utah corporation are mere formalisms, that they are designed for the protection of those who might be prejudiced—"stockholders, creditors, or even tax authorities where a tax is actually owing"—, that the Tax Commission has not been prejudiced and has no right to complain as a creditor in this case because

by the Court's own opinion it is now adjudged that no tax is owing by the corporation.

We cannot help but express our concern at such an infirm, shallow and feeble argument which, in essence, asserts that the state has no right to complain because there is no tax owing and then asserts that there is no tax owing because the state has no right to complain. Not until this Court's decision has become final will it have been adjudged no tax is owing. The Court's present opinion, unless changed, will be difficult enough as a precedent in the future without having it cited against us at this stage while we are all struggling to help the Court determine whether or not it is correct.

POINT I

THE UTAH STATUTES RELATING TO THE LIQUIDATION AND DISSOLUTION OF UTAH CORPORATIONS WERE SPECIFICALLY DESIGNED FOR THE PROTECTION OF THE UTAH STATE TAX COMMISSION, AMONG OTHERS, AND THE COMMISSION HAS A RIGHT TO COMPLAIN HERE OF THEIR VIOLATION.

Under Section 18-2-17, the capital of a corporation cannot be paid over to the stockholders "except as provided by law." The legal requirements for such withdrawal are six in number, namely:

(1) Payment of the corporation's debt and taxes or the making of adequate provision therefor.

(2) Approval of the plan of liquidation and dissolution by a two-third vote of the stockholders.

(3) Prior to distribution of the assets, depositing with the *State Tax Commission* and with the Secretary

of State an affidavit that all debts and taxes have been paid or provided for.

(4) Prior to distribution of the assets, depositing with the *State Tax Commission* and with the Secretary of State a verified copy of the resolution by the shareholders authorizing the liquidation.

(5) Prior to distribution of the assets, depositing with the *State Tax Commission* and with the Secretary of State an affidavit that a copy of the liquidation resolution was mailed to every non-participating shareholder.

(6) Prior to distribution of the assets, depositing with the *State Tax Commission* and with the Secretary of State proof that notice was published once a week for three consecutive weeks in a newspaper to inform the public it was ceasing to do business as a corporation and giving the dates on which distribution of assets would be made.

Also, Section 103-12-4 of the Penal Code provides in part as follows:

> "Every director of any stock corporation who concurs in any vote or act of the directors of such corporation or any of them by which it is intended either:
>
> (2) To divide, withdraw or in any manner, except as provided by law, pay to the stockholders, or any of them, any part of the capital of the corporation; * * *; — is guilty of a misdemeanor."

We have previously pointed out that Plaintiff flagrantly violated the above provisions. Of the six require-

ments, only one was met, namely, the approval of the stockholders to the plan of liquidation. The other five requirements were admittedly violated. Plaintiff's approach has been to discuss each violation separately and dismiss it because it is such a small thing. We are not here faced, however, with a case of substantial compliance. We are faced with the wholesale violation of statutes designed expressly and specifically for the protection and benefit of the State Tax Commission.

When the statute states that the capital assets cannot be withdrawn from the corporation except where the necessary affidavits and proofs have been deposited with the State Tax Commission *prior to the distribution of the assets,* we think it is pretty obvious that this statute was designed for the protection of the State Tax Commission. It is not a statute designed solely for the protection of stockholders and creditors. Therefore, when Plaintiff in black-faced type asks "Just whom then is the Commission looking after?", the reply is obvious.

What can the meaning and the legislative intent of these requirements be if not to permit the State Tax Commission to ignore for tax purposes those abortive transactions which plainly violate the clear terms of the statute? Is violation of the statute to be given the same effect as compliance? Does illegality merit such high reward?

Just as Plaintiff concedes that minority stockholders or creditors can make the stockholders "put it back", so also under this statute can the Tax Commission

make the stockholders "put it back" for tax purposes. When the statute requires notice to the State Tax Commission, it is prejudiced and seriously prejudiced when this notice is not given. The Tax Commission has several thousand domestic and foreign corporations on its corporation franchise tax rolls. How can it possibly audit these returns and determine tax liabilities if it cannot follow and rely on the status of the corporations as they appear on the records of the state as required by the statutes?

Plaintiff's argument that the Tax Commission has no right to complain because there is no tax actually owing begs the question. It overlooks the fact that the point involved here is one of status, the status of Budget Homes, Inc. as a corporation. It was given corporate status by the law and this status cannot be dissolved except by law. To argue that the several things which give and take away that status are little things—"pure formalism"—is unsound.

A marriage license and indeed the marriage ceremony itself may be regarded, under this view, as small things—"pure formalism"—but they are essential. A divorce decree is, after all, only a piece of paper but it is mandatory. An adoption proceeding may be regarded as a mere legal ritual, the appointment of a guardian as a lot of legal mumbo-jumbo, but in all these matters of status the law, as we understand it, is quite careful to surround both the creation and dissolution of the status with certain legal requirements and safeguards. These requirements are not "pure fomalism," they are essential to such status. Individuals acquire corporate status by

statute and cannot terminate such status except by statute.

It is true in this case that Prudential, a very large creditor, has not complained. There was no need for it to complain. The abortive liquidation which took place here was so illegal that insofar as Prudential was concerned it could be completely ignored. Under the statute, the debts of Budget Homes, Inc. to Prudential should have been paid prior to the distribution of the assets repeat prior to the distribution of the assets. They were not. The corporation continued personally liable for its debts to Prudential. Prudential's rights on the mortgaged assets continued unimpaired, its rights as creditor against the unmortgaged assets were in no way disturbed. We suggest that what Prudential did or did not do, what it may or may not have done, does not affect in the slightest the right of the Tax Commission to look after its interests.

Plaintiff emphasizes (p. 5, 9, 10) the provision (Sec. 18-2-17.11) which requires the suit for dissolution to be filed in court within 90 days from distribution except where "sufficient reason" appears. He argues that installation of the meter boxes and doing necessary road work constitutes sufficient reason for the time lag in this case between resolution date and filing of the suit in court and that in any event this is a matter for the District Court to determine, not the Tax Commission. It is a pleasure to agree with at least one of Plaintiff's arguments. Unfortunately, however, this argument is beside the point. We are arguing that the Tax Commission cannot accept the legitimacy of the liquidation in

this case, not because of the delay between resolution date and filing of the dissolution suit (Sec. 18-2-17.11), but because under Sec. 18-2-17, another section, assets cannot be distributed to shareholders in advance of a court decree unless prior to the distribution of the assets repeat prior to the distribution of the assets, the necessary affidavits and notices are filed with the State Tax Commission.

Plaintiff makes a point (p. 9) also of the fact that the dissolution provisions are in the chapter on corporations and are not revenue measures because not contained in the chapter relating to taxation. This point, although unsound, merits some discussion. Actually, these provisions are partly in the corporation law, (Sec. 18-2-17 et seq.), partly in the Judicial Code (Sec. 104-42-1 et seq.) under "Voluntary Dissolution of Corporations," and partly in the Penal Code (Sec. 103-12-4). However, we concede they are not in the chapter on taxation. At the same time, we do not concede that they have nothing to do with taxation. Obviously they do. The State Tax Commission is specifically mentioned in Sec. 18-2-17. Assets cannot there be distributed to shareholders unless prior to the distribution of the assets repeat prior to the distribution of the assets certain affidavits and notices are filed with the State Tax Commission, including an affidavit that all known debts *and taxes* have been paid or provided for. The Corporation Franchise Tax Section of the Auditing Division carries on a considerable amount of its activity under this section of the corporation law. This section in turn is tied

in with the criminal provision (Sec. 103-12-4) which excepts those withdrawals by shareholders which are "provided by law." Section 104-42-6 of the Judicial Code also has a lot to do with a corporation's tax liability. It contains provisions relating to the tax certificate from the State Tax Commission before dissolution by the court. More importantly, however, it provides:

> "The tax liability of the corporation shall be determined as of the date the corporation formally resolved *in a proper resolution* to quit doing business as a corporation, provided, however, that if a corporation does business other than in the normal course of liquidation, and winding-up its affairs, after the date determined in said resolution, the tax liability of said corporation shall be fixed as of the date the corporation actually ceased doing business."

It is this important provision, on final analysis, in relation with its companion provisions in the corporation franchise tax law, the corporation law and the penal code, which must be construed by this Court to decide this case. Plaintiff's suggestion that the above provision is not in the taxation chapter and, therefore, has nothing to do with taxation is clearly absurd. Although it would be highly desirable if the legislature put all provisions relating to taxation in the chapter on taxation, the Tax Commission cannot avoid its duty to administer the state's tax laws wherever they may be found.

For example, there is nothing in the Inheritance Tax Law authorizing the Tax Commission to release

inheritance tax liens. Fortunately, however, placed in an obscure corner of the Judicial Code under the heading "Termination of Life Estate" (Sec. 104-41-1) is such authority. Are the many releases issued over the years by the Commission invalid for this reason?

The Court cannot, therefore, avoid a consideration of the above quoted provision in the Judicial Code which determines when and how the tax liability of a corporation in liquidation and dissolution is cut off.

Again, we say it sets forth in effect three simple rules:

> (1) If the corporation does not liquidate according to law, it continues so far as the State Tax Commission is concerned until it is liquidated according to law.
>
> (2) If it liquidates lawfully, its tax liability is determined as of the resolution date, provided its activities thereafter are confined to winding-up its affairs.
>
> (3) If it liquidates lawfully but continues to do business after the resolution date, its tax liability is determined as of the date it actually ceases to do business.
>
> > (a) If the post-resolution business is production only with no selling, tax is computed on either the minimum or property basis, whichever is higher.
> >
> > (b) If the post-resolution business is production and selling, tax is computed on either the minimum, property or income basis, whichever is higher.

We think the present case can only fit under sub-

division (1) above. Plaintiff's Reply Brief contains a lot of remarks about the crown jewels of Utah, the splendid virtues of consistency, the fact that the Commission is judge, prosecutor, jury, etc., but we have so far been unable to penetrate these various remarks deep enough to determine in which category Plaintiff thinks his case falls.

Plaintiff can hardly contend it falls under (2) above so as to completely cut off the tax liability as of October 31, 1947 because by its own tax returns filed for the years 1948 and 1949 it continued as a corporation doing business in Utah after that date. Furthermore, it continued by the evidence in this case to exercise its corporate powers by installing meters, constructing a road and showing up in person at each closing transaction of each sale of each house to sign the substitution agreement with Prudential under which the debt owing by Budget Homes, Inc. was taken over by the purchaser. If, by some stretch of the imagination, this post-resolution activity is regarded as winding-up activity only, the taxes voluntarily paid with its returns for 1948 and 1949 were collected in error. On the other hand, if this post-resolution activity is something more than winding-up activity and assuming the lawfulness of the liquidation, the question then would be, does the case fit under 3 (a) or 3 (b)?

In its most favorable light, Plaintiff's strongest case would be an attempt to fit under 3 (a). A somewhat plausible case could perhaps be built up along this line. The difficulty of Plaintiff's position in this regard, how-

ever, is that it completely overlooks the requirement of the statute that to distribute the assets to the stockholders the corporation must file the necessary affidavits and notices with the Tax Commission prior to the distribution of the assets repeat prior to the distribution of the assets, which requirement was clearly intended for the benefit and protection of the Tax Commission. However, if the Court construes this requirement as requiring the Commission to get the directors of Budget Homes, Inc. thrown into jail under Sec. 103-12-4 of the Penal Code to secure compliance with the provisions of Sec. 18-2-17, and as not authorizing the Commission to ignore the so-called liquidation when Sec. 18-2-17 has been clearly violated (which, of course, would destroy category (1) above), Plaintiff is then faced with the difficulty of fitting in 3 (b) rather than 3 (a) because of its participation in each sale of each house at each closing transaction.

Plaintiff's remarks on page 7 completely gloss over the fact that at each sale of each house at each closing transaction, the President of Budget Homes, Inc. showed up in person on behalf of Budget Homes, Inc. and joined in an agreement with Prudential and the purchaser, together with the stockholders. Here, acting under its corporate powers and in consideration of various promises, waivers and representations, Prudential released the debt of Budget Homes, Inc. on that particular house, it being in the agreement assumed by the purchaser. What more active participation by Budget Homes, Inc. in the sales is necessary to put it in 3 (b)

above? The individual sales could not be made by the stockholders of Budget Homes, Inc. without the participation of Budget Homes, Inc. in the sale. The financing of a sale is an integral part of a sale. Budget Homes, Inc. in signing the substitution agreement in effect transferred its financing arrangements with Prudential to the purchaser. The purchaser stepped into the boots of Budget Homes, Inc. We ask the Court to take another look at the substitution agreement appearing at pages 81-82 of the Record. Subdivision (1) above fits this case, but if it doesn't 3 (b) must. In either (2) or 3 (a) Budget Homes, Inc. would be a square peg in a round hole.

In the *Pace* Case, 91 Utah 132 (1936), the Court in considering Sec. 103-12-4 in another connection stated (p. 137):

> "It would seem that the implication from sub-division 2, 103-12-4, which makes it a misdemeanor for a director to concur in any vote by which it is intended to pay to a stockholder any portion of the capital was that it would be against public policy to do the very thing which makes it a crime for such director to concur in."

To decide this case in Plaintiff's favor the Court must hold that Sec. 18-2-17 has criminal but no civil sanction and that the participation of Budget Homes, Inc. in each sale of each house at each closing transaction was a mere nothing at all. If the Court meets these issues and decides that Plaintiff should still prevail, Plaintiff will find the Commission to be a good loser.

CONCLUSION

This case is an important case from the standpoint of the need of the Commission and the corporate taxpayers of the state for guidance in determining when and how state tax liabilities are to be terminated in liquidation and dissolution proceedings. The statute as we interpret it is both fair and workable from the administrative standpoint. It seems little enough to ask the members of the Bar of this state to follow the statute and, to insure compliance, to continue assessing the franchise tax against the corporation until the statute is followed. The tax itself is small while the corporate privileges granted by the state are great. The Court's present opinion gives the Commission very little light on a difficult administrative problem because it doesn't consider the problem. The effect of the decision is to condone the most flagrant violation of our statutes which were clearly intended to give some measure of protection to the Tax Commission in the discharge of its duties.

The case, unfortunately, seems to have been regarded by the Court as a tax avoidance problem. From the state's standpoint, this is not so. We attack the transaction simply by virtue of the wholesale and flagrant violation of the state statutes which set forth an orderly and sensible procedure for the liquidation and dissolution of Utah corporations. Whether or not by winning the case, the state would get additional tax from these taxpayers is very doubtful. On the face of it, we are caught in the position of attempting to collect a 3% tax from the corporation when presumably 5% tax has

already been paid by the stockholders. Whether or not after putting the income back, the Commission should permit some portion to be treated as salary withdrawal (deductible) or dividend withdrawal (non-deductible) remains to be seen. Of if the stockholders actually put the money back and file claims for refund of their individual tax they may want to keep it in the corporation. It is impossible to say. In any event, it should be obvious that the case is not a tax avoidance problem so far as the state is concerned.

On the other hand, it is equally clear that the case does involve the avoidance of Federal taxes. Federal income taxes are now at such high levels on both corporations and individuals that the use of collapsible corporations has become quite widespread. By use of this device the corporation tax is avoided because the corporation does not sell and the gain to the stockholders who do sell is not taxed as ordinary income but is treated as capital gain arising from liquidation of the corporation's assets. The Bureau of Internal Revenue has attempted to meet this problem by suits under the *Court Holding Company* doctrine and recent legislation by Congress attempts also to deal with the problem.

If Budget Homes, Inc. and its stockholders think they can reduce their Federal taxes legally in the Utah courts, that is their prerogative. Let us be sure, however, that when the decision of the highest court of Utah

sets sail into the Federal courts to engage in the battle of collapsible corporations, the decision is seaworthy enough to stand the strain.

Respectfully submitted,

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